Universal Ferro and Allied Vs. Inspecting Assistant

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SooperKanoon Citation : sooperkanoon.com/65312

Court : Income Tax Appellate Tribunal ITAT Mumbai

Decided On : Feb-28-1992

Reported in : (1992)41ITD427(Mum.)

Judge : U Shah, S Vice-, G Veerabhadrappa

Appellant : Universal Ferro and Allied

Respondent : inspecting Assistant

Judgement :

1. This appeal by the assessee arises out of the order dated 20th January 1988 of the Commissioner of Income-tax (Appeals) for the assessment year 1984-85.

2. The assessee is a company. For the assessment year 1984-85, its previous year ended on 30th September 1983.

3. The first issue in the assessee's appeal relates to disallowance of a provision of Rs. 64,65,084 and a loss claimed on account of valuation at Rs. 77,46,668. The Assessing Officer found that, in the profit and loss account, the assessee has debited a sum of Rs. 64,65,084 as "liability on unfulfilled export obligations". The facts relevant to this claim are that the assessee was granted industrial licence to manufacture 45,000 metric tons of ferro manganese/silico manganese per annum with an obligation to export the entire production during the first ten years. Subsequently, the industrial licence was amended whereby the assessee was obliged to export 50 per cent of the production of 45,000 metric tons per annum

during the first ten years.

It was stated that the total cumulative production up to the end of the previous year was 45,135 metric tons. Therefore, the assessee was required to export at least 23,067 metric tons but the assessee exported only 12,709 metric tons till the end of the previous year resulting in a cumulative shortfall of 10,358 metric tons. It is in respect of this export obligation, which remained unfulfilled, that the assessee has placed the value at Rs. 64,65,084 by debiting the profit and loss account. The assessee explained the basis of this valuation by its letter dated 2-10-1986, which contained the following:- As on 30th September, 1983, the stocks available with Uniferro International were 5,646.259 MT only. So we had valued the said stocks at the international prices (Rs. 2,846 per MT) and the value worked out to Rs. 1,60,69,253. For the balance quantity of 4,712.161 MT, we considered the difference between the international price and the cost of production/which worked out to Rs. 1,372 per MT (Rs. 4,218 - Rs. 2,846) and the amount of Rs. 64,65,084 was debited to the Profit & Loss account.

It was claimed by the assessee that such liability has been provided as it has been following mercantile method of accounting. It claimed to be so supported by the decision of the Supreme Court in the case of Kedarnath Jute Mfg. Co. Ltd. v. CIT [1971] 82 ITR 363. Several other authorities were also relied upon before the Assessing Officer.

According to the assessee, unless the said liability is provided, the profit and loss account will not be able to represent the true and fair view of the profit/loss. The Assessing Officer rejected the assessee's contention by holding the said liability as contingent. According to the Assessing Officer, there were certain uncertainties, which made the liability a contingent one. Such uncertainties were detailed as under :- (a) The assessee was to export 100 per cent of the production earlier. It represented to the Government of India & then the export obligation was reduced to 50%. The assessee has further taken up the matter with the Government of India & the terms of licence may further be modified.

(b) When in future the assessee exports goods t a fulfil the quota of export obligation, there may be revival in the international market and the goods may fetch remunerative prices. The assessee is providing for the liability now according to the present international market conditions, but the export will take place on some future uncertain date. The liability is contingent on the market conditions that will prevail when exports are actually done.

(c) Till February 1987 the Government of India has not strictly enforced the condition by taking over assessee's goods for export. A show-cause notice was issued to the, assessee and it was asked to pay liquidated damages to the extent of Rs.5lacs. But against this order the assessee is in appeal. When and to what extent the terms will be enforced and at that time what will be the international market conditions are uncertain.

Thus the Assessing Officer came to a conclusion that the liability in respect of the assessee's export obligation was a mere contingent one.

Therefore, the sum of Rs. 64,65,084 debited to the profit and loss account was held disallowable.

3.1 The assessee had a closing stock of 5,646.259 metric tons as at the end of the previous year. The assessee has valued the said closing stock at the international price of Rs. 2,846 per metric ton. But that Assessing Officer has rejected this valuation and valued the entire closing stock at Rs. 4,218 per metric ton, which represents the cost price. According to the assessee, the goods were mainly meant for export purposes and it was justified in valuing the closing stock at the international market price, which was very much lower to the cost price. The Assessing Officer treated it as a change in the method of valuation of the closing stock. In the past, the assessee has valued the closing stock at cost or market price, whichever was lower. The market price was taken from the prevailing rate in the local market and international market rate was not taken at all. The Assessing Officer has also considered that most of the sales in subsequent year were in local market. By this, he did not accept the assessee's basis of the valuation of the closing stock. The difference in the basis of valuation resulted in an addition of Rs. 77,46,668.

3.2 The assessee objected to these determinations before the CIT (Appeals).

4. The Commissioner of Income-tax (Appeals) has dealt this issue in paragraphs 5 to 9 of his order, which are reproduced below :- (5) The production of the appellant started in the immediately preceding year where also the same treatment and conditions were in existence but the appellant did not make any adjustment in that year and cumulative adjustment on both accounts has been done only in this year. In any case, only incremental adjustment could have been done in this year and not the total.

(6) The main argument of the appellant is that as per the decision of the Supreme Court in the case of Kedarnath Jute Mills (82 ITR, Page 166) the liability even though uncertain was to be provided and was allowable as deduction and the mere fact that there is difficulty in estimation of liability or its quantification would not detract from its availability.

(7) On the other hand, the IAC has stated that the liability is contingent one and because the efforts of the appellant to further liberalise the conditions has still not become final the exact quantum of liability is not known on this account. Further, the show-cause notice for this default has been issued by the Joint Controller after the close of the accounting period and there again the liquidated damages of only Rs.5,00,000 has been imposed against which the appellant is in appeal. Further, the appellant may export the goods in future when there may be revival in the International market and which may fetch a remunerative price and till February 1987 the Government of India has not enforced the condition of taking over the appellant's goods for export. The IAC has cited the case of M.S.P. Sunithikumar Nadar & Sons. v. CIT [1957] 32 ITR, Page 138 (Madras) in support of this stand that it is a case of contingent liability, the facts being similar. The appellant, on the other hand, distinguishes this case saying that in the case cited by the IAC there were three different methods but in the appellant's case there is no alternative.

(8) I have gone through the contract and the entire correspondence in this behalf. The appellant has consciously chosen not to export the goods because the Interenational price was lower than the local price. The decision of the Supreme Court in the case of Kedarnath Jute Mills (82 ITR, Page 166) was rendered in the context of statutory liability and not contractual liability and, therefore, total reliance

cannot be placed on the same. As per the terms of the contract and the conditions attached thereto dated 16th April, 1979 paragraph 5 of the said contract is significant which provided for liability in the case of failure to satisfy its obligations, it says- It in any given year, the company tails and/or neglects or is not able to export 45,000 tonnes of its production of Ferro Manganese and Silico Manganese, then in such an event the company shall, on being called upon to do so by the Chief Controller of Imports and Exports, New Delhi, or Joint/Deputy Chief Controller of Imports & Exports, by a letter, hand over within thirty days from the date of the said letter to the State Trading Corporation of India Ltd. or such other person, firm or body corporate as the Government on Chief Controller of Imports & Exports, New Delhi, may nominate the difference between the stipulated annual commitment/obligation and actual exports of Ferro Manganess and Silico Manganese produced during the year (subject to a maximum of 45,000 tonnes of the production for that particular year) for export by the Agency at such price as it is able to obtain abroad. The company shall in addition pay simultaicously a sum equal to 5 per cent of the annual export obligation for every year of non-compliance of Clause 1, subject to a maximum of Rs. 5 lakhs by way of liquidated damages to the Agency. The Agency after export and realisation of sale proceeds of the aforesaid Ferro Manganese and Silico Manganese as expeditiously as possible shall give to the company the rupee equivalent of the net foreign exchange earned by the Agency on such export after deducting such expenses (including the Agency's normal commission) which have been incurred by the Agency.

The above, clause has been quoted in extenso to show that the liability is not arising automatically but is dependent on the company being called upon to do so by the Chief Controller of Imports and Exports of New Delhi. This event has not occurred so far and only a show-cause was issued on 25th June, 1984 by the Chief Controller of Imports and Exports and for non-compliance of the show-cause which was also issued after the accounting period, only liquidated damages of Rs. 5,00,000 has been asked for, which has also been contested. The appellant has so far not been asked to hand over the products to the State Trading Corporation of India Ltd. In the above referred circumstances, I totally agree with the IAC that as per the contract itself the liability has not arisen in this accounting period and the decision of the Madras High Court squarely applies on the facts of this case and, therefore, the provision for anticipated loss made of Rs. 64,65,084 was not allowable as deduction.

(9) Closely related to the above is the claim of the appellant for changing the method of stock valuation. It still remains to be cost or market whichever is lower but market price has been taken as the International price rather than the local price which is even higher whereas market International price is lower and therefore claim of Rs. 77,46,668 has been made. This change in method of stock valuation is not warranted as the appellant has chosen not to export goods consciously and the market price refers to the local price.

This will be in conformity with the past method also. Further, the appellant may choose to export in future years when market is available and, therefore, artificial reduction in valuation of closing stock was neither warranted nor bona fide and, therefore, the action of the IAC in not permitting under-valuation of closing stock is in order which is confirmed.

5. The assessee is aggrieved by the above order and disputes the disallowance and addition made. The assessee has filed the first set of paper book containing 88 pages and, at our instance, has also filed second set of paper book containing the proceedings before the Jt.

Chief Controller of Imports and Exports. The assessee, relying upon the paper book and the conditions of licensing filed in pages 14 and 19 of its paper book, contended that the assessee was under an obligation to export its production. Reliance was placed to pages 36 and 37, which relate to forfeiture order issued to the assessee by the Controller of Imports and Exports. Reliance was also placed on to the agreement dated 16th day of April 1979 between the assessee and the Government of India accepting the export obligations imposed under import licence for enablingthe import of plant, machinery and equipment necessary for establishing the industrial unit. Such agreement is placed in pages 41 to 47 of the paper book. The decision of the Controller of Imports and Exports on the assessee's appeal in respect of the export obligations is also filed at page 48 of the paper book. The assessee has placed on record at page 49 the various authorities on which it relied upon before the tax authorities. Relying upon all these, the assessee reiterated what has been contended before the Assessing Officer and also CIT (Appeals). The assessee submitted that the loss of Rs. 64,65,084 was not in the nature of contingent liability but in the nature of contractual liability arising out of agreements entered by the assessee with the Government of India in pursuance of the licensing policies of the Government, Had the assessee followed the obligations under export, the assessee would have incurred the loss due to unfavourable export market and the entire results disclosed by the assessee would be subject to the export obligations and actions of forfeiture, etc. on the part of the licensing authorities. The claim of the assessee viewed from these angles, it was submitted, should be accepted and the disallowance was not properly made. According to the assessee, difficulty in estimating the liability did not convert the accrued liability into a conditional one.

5.1 As regards the valuation of the closing stock, the assessee justified the valuation at the international market price on the ground that there was an export obligation imposed on the assessee to compulsorily export 50 per cent of its production. The valuation has been done under the accepted principle of valuation in accordance with the standard accounting practice suggested by the Institute of Chartered Accountants of India. In the context in which the assessee was under an obligation, the assessee's resort to take the international market price as against the high cost was very much justified and the addition of Rs. 77,46,668 was not proper. Reliance was placed on to the decision of the Allahabad High Court in Triveni Engg. Works Ltd. v. CIT [1987] 167 ITR 742.

6. The Departmental Representative vehemently opposed the contentions of the assessee. According to the Departmental Representative, the assessee's claim for loss of Rs. 64,65,084 has been rightly rejected holding the same as contingent liability. 6.1 As regards the loss arising on account of valuation, he submitted that the facts of the case and the market under which the assessee operated, decide the market price to be taken as, according to him, the assessee sold its production in the local market, the local market price would be relevant. The assessee by resorting to international market price has only offered arbitrary basis for valuation of the closing stock. Such valuation, if accepted, will result in not appreciating the

assessee's facts and the relevant market price in relation to the assessee's conditions of business. He heavily relied on the order of the CIT (Appeals) on the issue. According to him, the disallowance has been properly made so also the addition in respect of the under valuation of the closing stock.

7.1 We are unable to appreciate the assessee's contention. There was an obligation to export 100 per cent of its production. The licensing authority has reduced such obligation to 50 per cent of production. The assessee has been negotiating with the licensing authorities for mitigating the hardship caused to it in respect of export obligations.

Clause 5 of the agreement entered into by the assessee with the Government of India, which is reproduced above, stipulates the consequences of the non-fulfilment of the export obligations. From the perusal of the above condition, the liability of the assessee is conditioned on being called upon to do so by the Chief Controller of Imports & Exports, New Delhi. The company could also be subject to liquidated damages to the agency so nominated in this behalf. The assessee has also filed its appeal before the Jt. Chief Controller of Imports & Exports, Bombay, pleading impossibility of performance and appealing for waiver of these conditions imposed in the C.G. licence granted, The assessee is pursuing its appeals on the issue before the appropriate authorities. In this view of the matter, the liability has not crystallised as at the end of the previous year in question. The liability is contingent upon the authorities ultimately refusing to allow the assessee's appeal with regard to the above matter. In our view, taking background of these facts, the tax authorities have correctly treated the entire liability as in the nature of contingent liability. This is not a definite liability imposed on the assessee by a statute but purely arises out of contracts pursuant to licence.

Taking that view of the matter, until the liability is crystallized, we are unable to accept the assessee's contention that it should be treated as business expenditure of the year before us. Considering the totality of the facts and circumstances of the case, we agree with the reasonings given by the Assessing Officer and the CIT (Appeals) and reject the assessee's plea on the issue.

7.2 The decisions relied upon by the assessee do not help the assessee in relation to the issue before us.

7.3 As regards the valuation of the closing stock, the assessee's contention that it be permitted to value such closing stock in accordance with the market price prevailing in the international market, also deserves to be rejected. It is not the case of the assessee that it had, in fact, exported such closing stock in any subsequent year in pursuance of its export obligation. The trading account, which had carried the debits towards the opening stock and is further debited by purchases and credited by sales during the year will fail to disclose true profits/losses on such transactions unless the closing stock is properly arrived, correctly valued and credited to the trading account. Realising this, the report of the Tucker Committee of the United Kingdom, 1951, remarked :- ... The ideal method of making up the trading account of the year might be to charge it only with the cost of the goods actually sold in the year (corresponding to the sale process credited in that year) and to carry to a separate account all expenses relating to goods not sold in that year as in suspense on account of the next year's trading. In practice, this course is inconvenient, for no one can say at the time of purchases when the unsold goods will be sold. The same effect, however, (viz. that of confining the trading profit to the sales of the year), is obtained by a contra entry representing the goods unsold at the end of the year...

In view of the above considerations, the accountancy practice has devised sound methods of valuing closing stocks in order to arrive at the true results of the business, though there is nothing about this topic in the taxing statutes or in the Rule. This view is now approved by the Supreme Court in P.M. Mohammed Meerakhan v. CIT [1969] 73 ITR 735. It is said that in computing the profits and gains for the purpose of income-tax, two general and fundamental common places have always to be kept in mind. In the first place, the profits of any particular year or accounting period must be taken to consist of the difference between the receipts from business during that year and the expenditure laid out to earn those receipts, In the second place, the account of the profit and loss is to be made up consistently in accordance with ordinary principles of commercial accounting.

7.4 The cost or market value, whichever is lower, as a basis for valuation of closing stock has now come to be a recognised method for the valuation of the stocks. The term "market value" has been explained in Simon's Taxes B, Third Edition, pages 423 & 424 in the following manner:- The purpose of valuing stock at market price instead of cost is to provide for an anticipated loss on sale. The loss expected must be such as will arise on a sale in the ordinary course of business. The question as to what goods in stock are worth on a given day involves the contemplation of some market: it would not be right to value goods at a figure which could be got by having a break up sale, or a forced sale. The contemplation of a market involves two possibilities: the market in which the goods were bought and in which they will be sold. The first may be described as the replacement price of the stock; the second is their realisable value.

The Hon'ble Madras High Court in K. Mohammad Adam Sahib v. CIT [1965] 56 ITR 360, held that where the goods are saleable only in a foreign market and there is no local demand, the market value in such foreign business should be taken into account. Viewed from the above, principles, the market value to the assessee, in our view, means the relevant market in which he was operating during the previous year or intends operating in order to liquidate the stock held by him. In a nutshell, the market should be understood with reference to the assessee's context and conditions of business. Any other view will only render distortion of values of stock or depicting untrue results of business, strange to reasonable realities of business. The total market, both local and international, for any product will be so wide, the arrival of such market value will only result in practical difficulties of ascertainment. Such ascertainment could never be accepted as one free from a second. It will only result in arbitrary estimation of market value. The fact that prices of commodities fluctuate widely between any two markets, cannot be completely ignored.

If the assessee claims certain market value as relevant to him, he should be able to lead proper material like subsequent sale in such market. The assessee, no doubt, was under an obligation to export its production and was bargaining for relaxation of such obligations for business considerations. The assessee's under-valuation of the closing stock in the event of an export performance is only anticipatory in nature and does not bear from the events that are present in the assessee's business. The present anticipatory loss on the closing stock held, in our view, is not properly arrived at considering the realities of the assessee's business and events after balance sheet date. In the facts before us, it is not the case of the assessee that the assessee has no local demand for its products or has left with only that market at whose rates its stocks are so valued, for the purpose of liquidation of stocks. The cases relied upon by the assessee do not squarely apply to the facts of the case. In our view, the valuation placed by the assessee is only arbitrary and does not find support by any recognised principle of accounting. In these circumstances, we are of the opinion the addition made by the. tax authorities is reasonable and proper. An alternative ground that the assessee would be. entitled to claim deduction of Rs. 77,46,668 under Section 28 being in the nature of contractual liability, also does not merit consideration as the said liability is only contingent and has neither accrues OR the assessee nor arisen on account of the method of accounting followed by it. The assessee's claim on both the issues stands rejected. We see no reason to interfere with the order of the CIT (Appeals) on the issue.

8. to 23. [These paras are not reproduced here, as they involve minor issues].